STATE OF MICHIGAN
DEPARTMENT OF LABOR & ECONOMIC GROWTH
MICHIGAN TAX TRIBUNAL

LEM LLC,
Petitioner,

v

MTT Docket No. 301977

City of Durand,
Respondent.

Tribunal Judge Presiding
Jack Van Coevering

OPINION AND JUDGMENT

This matter was heard before Administrative Law Thomas A. Halick, who issued a Proposed Judgment on February 27, 2006. No exceptions or written arguments to the Proposed Judgment have been filed. The Tribunal, pursuant to Section 26 of the Tax Tribunal Act, as amended by 1980 PA 437, has given due consideration to the case file, and adopts and incorporates by reference the findings of fact and conclusions of law in the Proposed Judgment as the final decision of the Tribunal.

MICHIGAN TAX TRIBUNAL

Entered: April 6, 2006

By: Jack Van Coevering

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DEPARTMENT OF LABOR AND ECONOMIC GROWTH
MICHIGAN TAX TRIBUNAL

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CITY OF DURAND,
Respondent.

Administrative Law Judge Presiding
Thomas A. Halick

PROPOSED OPINION AND JUDGMENT

INTRODUCTION

This real property tax valuation case came before the Michigan Tax Tribunal for hearing on June 23, 2005, in Lansing, Michigan. Fred Gordon, Attorney at Law, represented Petitioner, LEM, LLC. Charles R. McKone, Attorney at Law, represented Respondent, City of Durand.

At issue is the true cash value of the subject property, known as the Country Village Apartments, an 84 unit apartment complex in the City of Durand. The tax years at issue are 2003, 2004, and 2005. In this proceeding, AV refers to assessed value, SEV refers to state equalized value, TV refers to taxable value, and TCV refers to true cash value. The property is classified for taxation purposes as Commercial Real property. The average level of assessment in effect for the subject property's classification for each tax year in question is 50%.

Each party offered testimony and documentary evidence. Petitioner's Exhibits P-1 through P-5 were admitted into evidence. Respondent's Valuation Disclosure (Exhibit R-1) was admitted into evidence. The parties stipulated to the admissibility of certain vacancy records identified as Joint Exhibits 1 through 5. Transcript, page 89. Each party filed a post hearing brief and a reply brief.

PROCEDURAL HISTORY

The 2003 property tax assessments were based on Respondent's estimate of the TCV of the subject property as of December 31, 2002. Petitioner appeared before the March 2003 Board of Review for the City of Durand to protest the TCV, SEV, AV, and TV of the subject. The Board of Review denied the relief requested and affirmed the tax assessments. On June 27, 2003, Petitioner filed a Petition with the Tribunal alleging that Respondent erred in its assessment of true cash value, state equalized value, assessed value and taxable value for the 2003 tax year. Respondent filed a timely answer. The Tribunal granted Petitioner's motions to amend its original Petition to add the subsequent tax years 2004 and 2005.

PARTIES' CONTENTIONS OF ASSESSED AND TRUE CASH VALUE

Petitioner contends that the property is assessed in excess of 50% of its true cash value and that the actual state equalized values, assessed values, taxable values and true cash values for the tax years 2003, 2004, and 2005 are as follows:

ID Number	SEV	AV	TV	TCV
20 82 015 000 00	$1,250,000	$1,250, 000	$1,250,000	$2,500,000

Respondent contends that the property is assessed at 50% of its true cash value and that the state equalized values, assessed values, taxable values and true cash values for tax years 2003, 2004 and 2005 are as follows:

2003

ID Number	SEV	AV	TV	TCV
20 82 015 000 00	$1,900,000	$1,900,000	$1,900,000	$3,800,000

2004

ID Number	SEV	AV	TV	TCV
20 82 015 000 00	$1,945,000	$1,945,000	$1,945,000	$3,890,000

2004

ID Number	SEV	AV	TV	TCV
20 82 015 000 00	$1,945,000	$1,945,000	$1,945,000	$3,890,000

(Respondent's final values are as set forth in Respondent's Reply Brief, page 4.)

TRIBUNAL'S CONCLUSIONS OF ASSESSED AND TRUE CASH VALUE

The Tribunal concludes that the true cash value and revised assessments of the subject property are as follows:

2003

ID Number	SEV	AV	TV	TCV
20 82 015 000 000	$ 1,400,000	$1,400,000	$1,400,000	$2,800,000

2004

ID Number	SEV	AV	TV	TCV
20 82 015 000 000	$1,432,200	$1,432,200	$1,432,200	$2,864,400

2005

ID Number	SEV	AV	TV	TCV
20 82 015 000 000	$1,432,200	$1,432,200	$1,432,200	$2,864,400

PETITIONER'S EVIDENCE, APPRAISAL AND EXPERT TESTIMONY

Petitioner claims that the true cash value should be based on the income method described in the appraisal report prepared by its expert witness Daniel F. Essa, MAI.

Petitioner's first witness was Michelle Perin, an employee of Perrin Construction, the manager of the subject property. Ms. Perrin is the daughter of the Evelyn Perrin, who is the sole member of LEM, LLC, the owner of the subject property.

Ms. Perrin claimed that there were considerable vacancies during 2003 and 2004. This situation arose in 2002 after Petitioner increased rents by $60 to $70 per month, per unit. The rents were raised to meet rising expenses. After this time, the complex experienced a loss of tenants, which Ms. Perrin believes was due to the increased rents.

On cross examination, Respondent's attorney questioned the witness regarding an appraisal report of the subject (not in evidence) which was prepared for Petitioner for refinancing purposes at that time. The witness acknowledged that such an appraisal report existed and confirmed that it was based on information provided to the appraiser by Petitioner's employees or representatives. That appraisal report indicated that there were no vacancies as of July 2004. It further indicated that there was a "waiting list" of tenants seeking to rent a unit at the subject apartment complex at that time. The witness stated that as of that precise time, it may have been true that there were no vacancies and that there was a waiting list. Furthermore, the report said there was not an oversupply of apartment units in the Durand area. (The Tribunal finds that this contradictory evidence undermines the credibility of Petitioner's vacancy and credit loss estimate used in the income approach.)

Petitioner's expert appraiser, Daniel F. Essa, MAI, LL.M., J.D., testified regarding an appraisal report prepared by his firm, Professional Appraisal Services, Inc, which concluded that the subject's TCV (fair market value) as of June 8, 2004 was $2,000,000. (The appraisal date was June 8, 2004 although the relevant tax day for the first year in question was December 31, 2002.) At the hearing, Mr. Essa recalculated his initial income approach value estimate, in which he had subtracted property taxes as an expense and applied a 10% capitalization rate. In his revised calculations he did not deduct taxes as an expense, but added 50% of the millage rate to the capitalization rate, which is consistent with recognized appraisal techniques when valuing property for ad valorem tax purposes. The property taxes of $135,000 (plus or minus) were not subtracted as an expense, but the millage rate of 60.65 was divided by two and added to the capitalization rate of 10%. Petitioner computed the overall capitalization rate (OAR) of 13.32%.

Mr. Essa relied primarily upon the income method because apartment properties are typically purchased by investors based on their income producing potential. Mr. Essa determined the potential gross income based on actual rents (which he determined to be consistent with market rents by comparison to similar properties) and ancillary income.

He determined that the actual vacancy and credit loss rate for the subject was 20%, which he adjusted to 15% to be consistent with the market. The vacancy and credit loss rate was applied to potential gross income to calculate "effective gross income." Net Operating Income was calculated by subtracting operating expenses, which were based on historical expenses of the subject and by comparison to expenses of similar rental properties. He arrived at a capitalization rate of 10% using the band of investment method and market extraction.

The comparable properties considered for determining the vacancy rate indicated market vacancy rates of 6%, 5%, 14%, and 4%. His appraisal report stated that occupancy rates in the subject's neighborhood range from 85 to 100 percent. Petitioner's Valuation Disclosure, page 72. He testified that due to low mortgage interest rates, many tenants have been moving into single family homes, thereby reducing demand for rental housing. Also, the tenants that move in to apartments tend to be less creditworthy, which increases collection losses. Transcript Page 46 (hereafter cited as "TR 46"). Mr. Essa testified that he looked at the historical statements for the subject for 2002 and 2003, which he claimed showed a high default rate and that rent concessions were granted, and that taken together, this indicated a 20% income reduction due to vacancy and credit loss (15% vacancy and 5% for bad debt). The historical gross income is shown at page 73 of Petitioner's appraisal report. He indicated that the rate used for purposes of the income method should not be as high as the rate for the subject during the one or two year period examined, but that 15% was a good indication.

There was no specific testimony regarding dollar amounts associated with the alleged "rent concessions" but Petitioner's witness merely stated that "that's our understanding that was what was being offered" and that other complexes were offering incentives such as two months free rent, no security deposit, and free move-in. TR 47.

On cross-examination, Mr. Essa indicated that he prepared the report with an associate, Timothy M. Conkright. Mr. Essa did not examine the interior of the subject's buildings but he observed the exterior by walking around the subject property.

In his income approach, Mr. Essa compared actual income and expenses to the market and developed a stabilized operating statement, which appears at page 75 of his appraisal report as follows:

Market Rate Rental Income			$610,980
Ancillary Income			$ 20,000
Potential Gross Income			$630,980
Less Vacancy & Collection Loss			($ 94,647)
Effective Gross Income			$536,333
Expenses	P.S.F.	Amount	
Fixed Expenses			
Ad Valorem Taxes	$1.72	$135,270	
Insurance	$0.44	$ 34,529	
Variable Expenses			
Management (5%)	$.034	$ 26,817	
Maintenance	$0.50	$ 39,238	
Contract Services	$0.40	$ 31,390	
Utilities	$0.65	$ 51,009	
Reserves	$0.20	$ 15,695	
Total Expenses	$4.25	$333,948	($333,948)
Net Operating Income			*$202,385

(*With property taxes deducted as an expense item, as it appears in the appraisal report.)

The NOI without the property taxes deducted as an expense item, as testified at the hearing, is as follows:

Total Expenses	$198,678	
Net Operating Income		**$337,935**

Mr. Essa used the “band of investment method” to determine a capitalization rate. He adopted a 75% loan to value ratio based on interviews with lenders; and, determined that a mortgage interest rate of 5% to 8% would apply to the subject, and concluded that the mean of 6.5% was reasonable. The equity dividend rate was developed by studying typical cash on cash returns for corporate bonds, municipal bonds, and US Treasury instruments. Considering the risk inherent in real estate investments such as the subject, he concluded that an appropriate rate of return on equity is 11%. Blending the mortgage and equity components, he concluded that the appropriate overall capitalization rate is 9.5% (rounded).

In addition, Mr. Essa extracted a capitalization rate from the sales used in his sales comparison method, resulting in an average rate of 11.47%. In conclusion, an overall rate of 10% was selected. Applying this rate to the NOI he arrived at an estimate of value as of July 2004 of $2,000,000 ($202,385 / 10% = $2,023,850). However, this was not Petitioner’s final contention of TCV.

At the hearing, Mr. Essa recalculated the TCV with the effective tax rate included in the OAR (rather than taken as an operating expense) as follows: $337,935 / 13.32% = $2,537,049. Petitioner’s final value conclusion under the income method (direct capitalization) is therefore: $2,500,000 (rounded).

With regard to the sales comparison approach, Petitioner’s appraiser chose four comparable sales of apartment complexes located in the subject’s market or a similar market. Sale No. 1 (Durand Apartments) is located in Durand and sold in February 2004 for $407,000.

For this property, 96% of its 24 units were occupied. Total rentable space is 19,200 square feet. Mr. Essa determined the sale price per square foot and made adjustments. Mr. Essa indicated this sale was his “best comparable” although admittedly “not as nice” as the subject. This property is in the same city and the sale occurred within two months of the July 2004 valuation date that he used for the subject.

Sale No. 2 is the Arlington Apartments located in Lansing, which sold for $1,325,000 in February 2001. This property was built in 1967, has 66 units, and a total of 65,910 square feet on three acres. The price per square foot is $20.10. The price per unit is $20,076.

Sale No. 3 is the Cambridge Manor Apartments located in Lansing, which sold for $1,341,000 in April 2002. The property has 36 units and 50,406 square feet, and was built in 1967. The price per square foot was $26.60. The price per unit was $37,250.

Sale No. 4 is an apartment building located at East Mount Hope Avenue, Lansing and sold for $293,000 in March 2002. The total building area is 10,490 square feet and there are 12 units. The price per square foot was $27.93 and the price per unit was $24,417.

Mr. Essa determined that no adjustments were needed for financing, conditions of sale, or date of sale. Adjustments for dissimilarities in location and physical features were based on “an analysis of variance in income potential.” Specifically, he divided the subject’s NOI per square foot by the NOI per square foot of the comparable property to obtain an “adjustment factor.” This factor was applied to the comparable property’s sale price per square foot of net rentable area, which adjusted the sale price per square foot for variances attributed to "either superior locational and physical characteristics, or both." For example, the NOI per square foot of Sale 3 is $3.35, compared to $2.58 for the subject. It is assumed that Comparable 3 achieves a higher NOI per square foot because it has superior locational and/or physical features. The subject's NOI per square foot divided by the comparable's NOI per square foot yields an adjustment factor of .7701.Therefore, the sale price per square foot of comparable three is adjusted from $26.60 to $20.41 ($26.60 X .7701 = $20.48). Applying this method to all the sales, Petitioner concluded an adjusted price per square foot of $24.00, which translates into an estimated value of $1,900,000 (according to page 99 of Petitioner's appraisal report). Giving equal weight to the sale price per square foot method and the NOI per square foot method, he concluded that the TCV of the subject as of June 18, 2004 is $1,930,000 based on the sales approach.

Petitioner did not use a cost approach based on his opinion that a typical investor would not rely on the cost approach. Petitioner' Post Hearing Brief contends that the income method is the most accurate approach to value for this investment property because apartment complexes are purchased by investors for their income producing capacity. Petitioner asserts there are no reported Michigan Tax Tribunal cases supporting the use of the sales comparison approach for an existing, stabilized, multi-family rental property. Rather, the case law supports use of the income approach for this type of property. *Northwood Apartments* v *City of Royal Oak,* 98 Mich App 721; 296 NW2d 639 (1980); Eversdyk v City of Wyoming, 10 MTT 664 (1999), MTT Docket No. 195925. Petitioner's appraisal report states that equal reliance was placed on the income method and the sales comparison method.

Vacancy Rate and Collection Loss. Petitioner contends that Respondent's vacancy and collection loss estimate is not reliable because the underlying data was obtained by an unreliable telephonic survey of several property managers during 2004 regarding the vacancy rates in 2002. No records were reviewed. On the other hand, Petitioner based its estimate on the prior net collected revenues by comparing the 2002 and 2003 actual revenues to the estimated projected rents at 100% occupancy. The rates for each year exceeded 15%. Michelle Perin testified regarding rent rolls that purported to document these vacancy rates. (Joint exhibits 1-5).

Replacement Reserves. Petitioner contends that its evidence supports an expense deduction for replacement and reserves of $15,695. Proper appraisal practice requires a separate estimation for replacement and reserves. The Appraisal of Real Estate, 11th Edition, American Institute of Real Estate Appraisers (1996).

Maintenance and Repair Expense. Petitioner's appraiser estimated annual expenses for repair and maintenance of $39,238 based upon the historical examination of the subject. It is appropriate to use actual expenses. *Northwood Apartments* v *City of Royal Oak*, 98 Mich App 721; 296 NW2d 639 (1980); MCL 211.27.

Aggregrate Expenses. After the hearing, Respondent disclosed an error in calculating actual expenses and submitted that the actual expenses were $223,000, which exceed Petitioner's contention of expenses ($198,678 – not including property taxes).

Capitalization Rate. Petitioner's capitalization rate of 10% is supported by rates derived from sales of comparable properties and by the band of investment analysis. Furthermore, it is appropriate to adjust the rate for taxes by an amount equal to 50% of the effective tax rate for a total rate.

RESPONDENT'S EVIDENCE, APPRAISAL AND EXPERT TESTIMONY

Respondent's case was presented through the testimony of Mr. Kern Slucter, MAI, SRA, ASA. Mr. Slucter prepared an appraisal report for the subject. Mr. Slucter testified that the subject has seven one-bedroom apartments and 77 two-bedroom apartments. One unit is used as an office, leaving 83 rentable units. In conducting an income approach to value, he relied upon financial information obtained from the property owner and from Respondent's assessor. He stated that he was skeptical of some of this information because certain items had been crossed out or typed over. TR 106. He was concerned that income was understated. Furthermore, the expense information appeared to be too high in his opinion. He found it difficult to discern from the records whether the property manager was including long-term expenses like the replacement of roofs or carpeting as a maintenance expense, as opposed to reserves. With regard to these items, he relied more heavily upon his understanding of typical market expenses. TR 107.

Respondent's appraisal report sets forth the asking rents, actual unit rent, unit size, location, and rent per square foot. The income approach first determined estimated market rents. Petitioner surveyed the subject's market and selected four comparable properties to examine market rents. Using the subject property's rent information, it was determined that the Potential Annual Rent for the subject was $601,680 for the first tax year at issue. Based on Mr. Slucter's interview with the on-site property manager in 2004, he determined that rents had not been raised in over one year, and concluded that "The subject property's projected rental rates for its units are considered to be near, if not lagging, market rates." He testified that the subject's rental rates were "pretty much a market rate…." TR 110. Respondent presented evidence of three comparable apartment buildings in Dewitt, Eaton Rapids, and Owosso with reported rents that equal or exceed the subject. Rents ranged from $590 to $655 per month per unit. It was concluded that the subject's actual rents reflect the market.

Mr. Slucter looked at vacancy rates reported by representatives of six comparable properties as follows: 4%; 1.7%; 6.3%; 0% 2.1%, and 0%. He indicated that these rates do not consider "lag vacancy, or turnover time, between tenants." Slucter learned from an on-site property manager of the subject that the largest incentive that had been offered was $100; occasionally the $25 application fee had been waived; but, there were no free rent programs. He concluded that an annual vacancy rate of 5% is reasonable for purposes of the income approach.

Operating expenses were determined by reference to historical expenses and market expenses of comparable properties. Below is a "Reconstructed Income Statement" substantially as it appears in Respondent's appraisal report, except for a correction of an error in the total expenses that Respondent disclosed in its post hearing brief.

Potential Gross Income			601,680
Estimated Vacancy and Credit Loss	-5%	-$ 30,084	
Effective Gross Income		$571,596	
Additional Income		$ 20,750	
Net Revenue			$592,346
Estimated Expenses			
Fixed			
Taxes		in cap rate	
Insurance		-$28,000	
Variable			
Management		-$30,000	
General & Administrative		-$18,000	
Building Services		-$54,000	
Maintenance and Repairs		-$43,000	
Replacement Reserves		(Included in Maintenance)	
Utilities		-$50,000	
Utilities Apartment Units – tenant			
Total Expenses			-$223,000[1]
Net Operating Income		**$369,346**	

Mr. Slucter developed an overall capitalization rate of 9.5%, to which he added 2.5% to reflect the tax burden not considered as an expense in the operating income statement" to arrive at an OAR of 12%. He considered both the band of investment method and the market extraction method. He determined that an 80% mortgage component and a 20% equity component were typical. According to Korpacz National Investor Survey, for the fourth quarter of 2001, investors

1 Respondent's appraisal report and testimony at the hearing indicated $173,000 in total expenses resulting in NOI of $419,346. Respondent's post hearing brief indicated that an error was made in calculating the expenses, which were revised to $223,000 resulting in NOI of $369,346.

purchasing apartment complexes applied rates between 8% and 10%. He determined that 9.10% was appropriate.

Rather than increasing the capitalization rate by one half the millage rate, he believed it was appropriate to adjust that rate to reflect market risk, and added 2.5% (rather than 50% of 60.65 mills) to the capitalization rate of 9.5%. Therefore, Respondent's corrected income approach results in the following: $396,346 / 12% = $3,080,383 ($3,100,000, rounded). The date of Mr. Slucter's opinion of value under the income approach was of December 31, 2002, for 2003 tax year. Under the income method he reached the same value conclusion for 2004. "We didn't see very much movement or change in market rents or market expenses as they were represented to us." TR 135. For the 2005 tax year he did not testify to an increase in the value determined by the income approach for market conditions because he "hadn't received the income and expenses for it in time to analyze it." TR 135.

Respondent's sales comparison method considered the following sales:

Sale 1 is located in Dewitt and sold for $3,100,000 in December 2002. The property was built in 2000 and has 36 units and 24,904 square feet.

Sale 2 is located in Perry and sold for $820,000 in April 2003. The property was built in 2001 and has 16 units with gross square footage of 7,788.

Sale 3 is located in Eaton Rapids and sold for $1,535,000 in September 1999. The property was built in 1998 and has 32 units and 34,704 gross square feet.

Sale 4 is located in East Lansing and sold for $2,250,000 in April 1999. The property was built in 1963 and has 69 units with total square footage of 44,385.

Mr. Slucter adjusted these sales for dissimilarities in market conditions, location, condition, construction quality, size, and economic characteristics.

Respondent's final contention of TCV is based primarily upon the sales comparison approach, and concluded to true cash values of $3,800,000 (2003), $3,890,000 (2004), and $3,967,800 (2005). (Respondent's Post Hearing Brief, page 13.) Respondent's Post Hearing Reply Brief, page 4 (August 19, 2005) reflects Respondent's final contention of TCV, and concluded that the TCV for both 2004 and 2005 is $3,890,000.

Respondent argues that the testimony of its expert is based on superior data and that the expert's observation of the entire property, interior and exterior, was more credible, and that he offered an opinion of value as of the three relevant tax days. Petitioner's expert should be discounted because he opined as to the value as of July 8, 2004, and made no specific allegation of value as of the relevant tax days. Respondent's expert photographed the exterior and interior of the property, inspected for quality and maintenance, and viewed the surrounding area, and several comparable properties, whereas, Petitioner's expert merely observed the outside of the property. Most of the actual appraisal work was performed by Mr. Essa's employee, a "Limited

Real Estate Appraiser" who did not testify, although he was the primary author of Petitioner's appraisal report.

FINDINGS OF FACT

This section is a "concise, separate, statement of facts" within the meaning of MCL 205.751; and, unless stated otherwise, the matters stated or summarized are "findings of fact" within the meaning of 1969 PA 306, MCL 24.285.

The parties stipulated to the following facts in paragraphs 1 through 8 below.

1. The subject property is located at 8940 E. Monroe Rd., Durand, Michigan.
2. The property is an eighty-four (84) unit multi-family apartment complex. The property has seven three story apartment buildings.
3. Seven (7) of the units are one (1) bedroom and seventy-seven (77) units are two (2) bedroom apartments.
4. The apartment buildings are wood frame construction with brick and vinyl exterior. The complex also has a building used for maintenance and storage.
5. The land area is 10.53 acres and is irregularly shaped.
6. The highest and best use of the property is a rental apartment complex.
7. The property is zoned Multi-Family Residential.
8. Durand is a home-rule city of approximately 4,000 residents located in Shiawassee County on I-69. The city is approximately 14 miles southwest of Flint and approximately 32 miles northeast of Lansing.

The subject property is commonly known as the Country Village Apartments in Durand, Michigan. Buildings “A to D” were built in 1987, and buildings “E to G” were built in 1999. The buildings are well maintained and in good condition. The site includes driveways, parking areas, sidewalks, carports, a storage building, and landscaping. Gas and electric and all public utilities are available to the property, including municipal water, sanitary and storm water sewers. One of the 84 units is used as an office. The property is classified for taxation purposes as Commercial Real property. The average level of assessment in effect for the subject property’s classification for each tax year in question is 50%. The affected school district is Durand Public.

The Tribunal finds that the income and expense data for purposes of the income approach are as follows:

Market Rate Rental Income		$601,680
Ancillary Income		$ 20,000
Potential Gross Income		$621,680
Less Vacancy & Collection Loss (10%)		($ 62,168)
Effective Gross Income		$559,512
Expenses	Amount	
Fixed Expenses		
Ad Valorem Taxes	Included in cap rate	
Insurance	$ 31,000	
Variable Expenses		
Management (5%)	$ 27,975	
Maintenance	$ 39,238	
Contract Services	$ 31,390	
Utilities	$ 50,000	
Reserves	$ 15,695	
Total Expenses	$195,298	
Net Operating Income		$364,214

The appropriate market rate rental income is $601,680. This is based on the actual monthly rents for each of the 83 rentable units as reported by Respondent. Both experts found that the actual rents were consistent with the market.

The reasonable ancillary income is found to be $20,000, which is for practical purposes the amount both appraisers used in their "stabilized" or "reconstructed" operating income statements in their appraisal reports. However, Respondent claims that this figure is too low, and that the actual "Income Statement" year ending December 2003 (Exhibit P-2) shows actual ancillary income of $56,474.56 for that year. This figure was based on the occupancy levels during 2003. It is noted that the "Income Statement" for year ending December 2002 (Exhibit P-2) indicates ancillary income of $19,735.89. Respondent contends that if actual ancillary income is used, it should not be reduced by the vacancy and credit loss, because the actual ancillary income was earned based on the occupancy rates during the relevant year, and therefore, the vacancy loss is already represented. Although this position is not without a logical basis, it is generally recognized that ancillary income is included in Potential Gross Income, from which the vacancy loss is deducted. This is the method Petitioner used, and there is no compelling reason to vary from this method here. The vacancy and credit loss should be deducted from the total potential gross income, which includes rental income and, "[a]ll other forms of income to the real estate – e.g., income from services supplied to the tenants, such as switchboard service, antenna connections, storage, garage space, and income from coin-operated equipment and parking fees." Appraisal of Real Estate, 12th Edition, page 511. In this case, both experts determined that ancillary income was approximately $20,000, as set forth in their respective stabilized or reconstructed operating statements. It is determined that Petitioner's method of including the ancillary income in PGI is proper. Therefore, the effective gross income is

$559,512.

Vacancy and Credit Loss. Based on the available, market vacancy rates, and the experience of the subject, the proper vacancy rate and collection loss is determined to be 10%. Neither party supplied complete or convincing proofs on this issue. However, both experts considered what they believed to be actual vacancy rates for the subject and vacancy rates for comparable properties. It would have been helpful to have evidence of historical vacancy rates of the subject for 2000 and 2001; however, no such evidence was introduced or considered by either appraiser.

Respondent's data on vacancy levels of comparable properties is not completely convincing because it was based on telephone interviews of property managers during 2004 for vacancy rates for previous years, which may have understated market vacancy rates. No actual vacancy records were reviewed for the comparables. It is unclear whether the responses included vacancies, tenant turnover, and nonpayment of rent, or were merely an estimate of units that were vacant at the time of the inquiry. Respondent's reported vacancy rates were: 0%, 0%, 1.7%, 2.1%, and 6.3%.

Petitioner considered the prior net collected revenues for 2002 and 2003. Comparing the 2002 and 2003 actual revenues to the estimated projected rents at 100% occupancy, the percentages for each of the comparable years were claimed to be approximately 20%. Petitioner also relied upon certain documents that were admitted into evidence after being used ostensibly to "refresh the memory" of Michelle Perrin during direct examination. Joint Exhibit 1 – "Apts

Vacant @ End of Month" for 2002, 2003, 2004, and part of 2005. Respondent questions the credibility of these documents because they were not identified or provided to the Tribunal or Respondent prior to the hearing. Furthermore, the document that allegedly shows the vacancies for 2002 has been changed by hand written notations on the document – that is, "2003" is crossed out by hand, and the year 2002 is handwritten in its place. This raises doubts as to when this document was created and how accurate it is. It must be noted that Michelle Perrin merely read from these records and did not appear to have any independent recollection of the precise vacancy rates during that time. Assuming *arguendo* that vacancies spiked after the rents were increased in 2002, the vacancy records and Ms. Perin's testimony demonstrate that occupancy increased in 2003, 2004, and part of 2005. This same experience is shown in Joint Exhibits 2, 3, and 4 (Rent Rolls dated 1/1/03, 12/31/03, and 1/31/04). Petitioner's own market data indicates that vacancy rates at comparable properties were 4%, 5%, 6%, and 14%. Petitioner's appraisal report states that "The vacancy rates [occupancy] in the subject neighborhood range from 85 to 100%." That report also notes that the subject was 93% occupied at the time of inspection in 2004. The market evidence shows only one property with a reported vacancy and credit loss rate of 14%, the highest reported, with the next highest being only 6.3%. Furthermore, rent concessions for the subject have not been proven. The income statements for years ending December 2002 and 2003 do not specify rent concessions and the income statement for 2004 shows "concessions" of only $53.34.

The vacancy and credit loss rate used in the income method should reflect what a knowledgeable investor would reasonably anticipate for the subject property over the expected holding period, looking forward from the relevant valuation dates. The Appraisal of Real Estate, 12th Ed., page 512. A prudent investor would consider the experience of the subject, but would also consider rates experienced by comparable properties.

Petitioner claimed that actual gross rents for calendar year 2003 equaled $491,148, and potential gross rent estimated by Petitioner was $610,980, which indicates an actual reduction in potential gross income due to both vacancy and collection losses of 20% (rounded) for the 2003 tax year. The actual gross rents for calendar year 2002, according to the Income Statement appended to Respondent's valuation disclosure, was $466,024, assuming potential gross rent was the same, this indicated a vacancy and collection loss rate of 24%, plus or minus. There was no testimony regarding vacancy rates for 2001 or prior. If it is true that the subject experienced a relatively high vacancy rate (which is not clear from this record) there is evidence that management decisions, such as a steep increase in rents, substantially contributed to the vacancies. The property is in good condition and there is no evidence of an oversupply of apartments in the subject's market. The subject's allegedly high vacancy rate is not corroborated by market evidence from comparable properties. The rates from comparable properties supplied by both parties are in ascending order as follows: 0%, 0%, 1.7%, 2.1%, 4%, 5%, 6%, 6.3%, and 14%. If the high and low figures are discarded, this would indicate an average of 4.1%. A potential purchaser would review the income statements including those appended to Respondent's valuation disclosure and would note the apparent difference between potential gross income and actual revenue from rents. In addition, it would be evident that rents were raised in 2002 by $60 to $70 per month per unit, which could explain the sudden increase in the vacancy rate during 2002 - 2003. These rent increases may have shocked some tenants into leaving. However, both experts agreed that the rents reflected the market, and therefore, it would also be reasonable to assume that with good management practices the vacancy and credit loss rate would resemble the market, rather than the 20% rate allegedly experienced by the subject, which appears atypical. The high vacancy rate that appears to have started during 2002 after rents were increased, was proven to be temporary -- the occupancy level gradually increased during 2003 and there is evidence that there was a waiting list as of spring 2004. The estimated vacancy allowance should reflect an appropriate stabilized vacancy rate and should not be unduly influenced by the recent experience of the subject immediately after rents had been increased. Petitioner's market adjusted estimate of a 15% rate must be discounted. Nevertheless, based on the evidence, some of which is conflicting, a prudent investor would likely apply a higher than average vacancy and credit loss rate in the income method. The Tribunal finds that the appropriate vacancy and credit loss rate is 10% for each tax year at issue, which is supported by a preponderance of the material, credible evidence that is relevant to this issue.

Insurance Expense. The Tribunal finds that insurance expense of $31,000 is supported by the income statements and also is near the mean of the competing figures presented by the parties to be reflective of the market. (Respondent = $28,000; Petitioner = $34,529.)

Management Expense. The Tribunal finds that the management expense is $27,975. This is based on the undisputed management fee of 5% of effective gross income.

Replacement Reserves. Petitioner offered competent evidence of the appropriate expense deduction for replacement and reserves in the amount of $15,695. On the other hand, Respondent did not include a specific expense deduction for reserves, but stated that the reserves were included under maintenance and repairs. Respondent provided no specific evidence to support this estimate, other than including $12,000 in its estimate for maintenance and repairs without explanation as how that figure was established. A deduction should be made for reserves to account for major repairs that a purchaser will reasonably anticipate in the future. See, The Appraisal of Real Estate, 11th Edition, American Institute of Real Estate Appraisers (1996). The Tribunal finds the estimate of Petitioner's appraiser is reasonable.

Maintenance and Repair Expense. Petitioner's appraiser estimated annual expenses for repair and maintenance of $39,238 based upon the historical examination of the subject. It is appropriate to use actual expenses. *Northwood Apartments* v *City of Royal Oak*, 98 Mich App 721; 296 NW2d 639 (1980); MCL 211.27. This was supported by historical costs, the market, and interviews with area brokers and agents.

Respondent's estimate for maintenance and repairs was based on "historical expense" taken from income statements for 2002, 2003, and part of 2004, which are included in the addendum of Respondent's report. Respondent's Appraisal Report, page 64. Respondent estimated annual maintenance and repair expenses plus reserves to be $43,000, of which $12,000 was attributable to reserves, which means that $31,000 was for maintenance and repairs. Based on the Tribunal's review of the 2003 income statement attached to Respondent's appraisal, the line-items that appear to describe "maintenance and repair" support the higher expense figure estimated by Petitioner.

Both parties deducted an expense for "contract services" or "building services."

Petitioner deducted $31,390 ("contract services") and Respondent deducted $54,000 ("building services"). The Tribunal finds Petitioner's figure to be more convincingly supported by the financial statements and Petitioner's appraisal report.

Utilities. There is no material dispute regarding the appropriate expense for utilities. It is found that $50,000 is reasonable.

*Aggregrate Expenses***.** The Tribunal concludes that the aggregate expenses for purposes of the income method total $195,298.

Net Operating Income. The net operating income is $364,214.

Capitalization Rate. The Tribunal finds that Petitioner's capitalization rate of 10% is supported by the band of investment method and rates derived from sales of comparable properties. For the mortgage component, Petitioner estimated an interest rate of 6.50 %, which was near the mean of rates available as of July 2004, which ranged from 1% to 4% over prime, for a mortgage interest rate of 5% to 8%. (Petitioner's lender's survey revealed slightly higher but similar results ranging from 6.25% to 9%. Petitioner determined a rate of 7.25% was appropriate.) Respondent based the equity component on alternative investment grade debt instruments (corporate bonds), with returns ranging from 5.28% to 6.81%. Petitioner estimated that the additional risk of a real estate investment like the subject would require an additional 500 basis points, which indicates an Equity Dividend Rate of 10.28 to 11.81 – which suggests that a reasonable Equity Dividend Rate is 11%. (Respondent did not cite rates available for alternative investments such as certificates of deposit, treasury bills, corporate bonds, but concluded that it was the appraisers "studied and considered opinion" that at appropriate cash on cash return would be 8.5% to 10%, and concluded that 10% was appropriate.) Blending the debt and equity components, Petitioner used a rate of 9.5% (rounded).

Finally, Petitioner's appraiser considered overall rates extracted from four sales that were included in his sales comparison approach. These rates average 11.47%. If the outlier of 12.58% is excluded, Petitioner's sales indicate a market capitalization rate of 11.1%. (The rates extracted from Respondent's sales averaged 9.46%, but excluding the rate of 7.99% that was derived from the dissimilar student apartment complex in East Lansing, the average would be 9.8%.) Based on the foregoing, Petitioner reasonably concluded that a 10% overall capitalization rate should be applied. Furthermore, it is appropriate to adjust the rate for taxes by an amount equal to 50% of the effective tax rate. (The millage rate in effect for 2003 was 60.65 mills.)

Respondent's rate of 9.5% was adjusted for taxes, however, it was not adequately explained why an effective tax rate of 2.5% was added to arrive at an overall rate of 12%.

Taking all the relevant evidence into account, it is concluded that a capitalization rate of 10% is well supported by the evidence and the expert testimony. This amount must be adjusted to include the effective tax rate. The applicable property tax rate is $60.65 per thousand (60.65 mills). This amount is first divided by 1,000 with the result of 0.06065. The property tax is calculated on 50% of the TCV, and therefore: 0.06065 x 0.50 = 0.030325. Next, the effective tax rate is added to the 10% OAR: 0.10 + 0.030325 = 0.130325, or 13.0325%.

CONCLUSIONS OF LAW

The assessment of real and personal property in Michigan is governed by the constitutional standard that property shall not be assessed in excess of 50% of its true cash value, as equalized, and that increases in the taxable value are limited by statutorily determined general price increases, adjusted for additions and losses. Michigan Constitution of 1963, Article IX, Sec. 3.

As used in the General Property Tax Act, "cash value" means the usual selling price at the place where the property to which the term is applied is at the time of assessment, being the price that could be obtained for the property at private sale. MCL 211.27(1).

A proceeding before the Tax Tribunal is original, independent, and de novo. MCL 205.735(1). "The petitioner has the burden of establishing the true cash value of the property...." MCL 205.737(3); MCL 211.27(1); *Meadowlands Limited Dividend Housing Ass'n* v *City of Holland*, 437 Mich 473, 483-484; 473 NW2d 363 (1991). "This burden encompasses two separate concepts: (1) the burden persuasion, which does no shift during the course of the hearing; and (2) the burden of going forward with the evidence, which may shift to the opposing party." *Jones and Laughlin Steel Corp v City of Warren*, 193 Mich App 348; 483 NW2d 416 (1992), citing: *Kar* v *Hogan*, 399 Mich 529, 539-540; 251 NW2d 77 (1976); *Holy Spirit Ass'n for the Unification of World Christianity* v *Dept of Treasury*, 131 Mich App 743, 752; 347 NW2d 707 (1984).

"True cash value" is synonymous with "fair market value." *CAF Investment Co* v *State Tax Comm*, 392 Mich 442, 450; 221 NW2d 588 (1974).

The Michigan Supreme Court, in *Meadowlanes, supra*, held that the goal of the assessment process is to determine "the usual selling price for a given piece of property." In determining a property's true cash value or fair market value, Michigan courts and the Tribunal recognize the three traditional valuation approaches as reliable evidence of value. See *Antisdale* v *Galesburg*, 420 Mich 265; 362 NW2d 632 (1984).

The three most common approaches to valuation are the capitalization of income approach, the sales comparison or market approach, and the cost-less-depreciation approach. *Meadowlanes*, at 484-485; *Pantilind Hotel Co* v *State Tax Comm*, 3 Mich App 170; 141 NW2d 699 (1966), aff'd 380 Mich 390 (1968); *Antisdale*, at 276. The Tribunal is under a duty to apply its own expertise to the facts of the case to determine the appropriate method of arriving at the true cash value of the property, utilizing an approach that provides the most accurate valuation under the circumstances. *Antisdale,* at 277.

Under MCL 205.737 (1), the Tribunal must find a property's true cash value in determining a lawful property assessment. *Alhi Development Co* v *Orion Twp*, 110 Mich App 764, 767; 314 NW2d 479 (1981). The Tribunal may not automatically accept a respondent's assessment but must make its own finding of fact and arrive at a legally supportable true cash value. *Pinelake Housing Cooperative* v *Ann Arbor*, 159 Mich App 208, 220; 406 NW2d 832

(1987); *Consolidated Aluminum Corp* v *Richmond Twp*, 88 Mich App 229, 232-233; 276 NW2d 566 (1979). The Tribunal is not bound to accept either of the parties' theories of valuation. *Teledyne Continental Motors* v *Muskegon Twp*, 145 Mich App 749, 754; 377 NW2d 908 (1985). The Tribunal may accept one theory and reject the other, it may reject both theories, or it may utilize a combination of both in arriving at its determination. *Meadowlanes*, at 485-486; *Wolverine Tower Assocaites* v *City of Ann Arbor*, 96 Mich App 780; 293 NW2d 669 (1980); *Tatham* v *City of Birmingham*, 119 Mich App 583, 597; 326 NW2d 568 (1982).

In this case, the Tribunal concludes that the law and appraisal practice favor the application of the income approach to this income producing rental property. *Northwood Apartments* v *City of Royal Oak*, 98 Mich App 721; 296 NW2d 639 (1980); *Eversdyk* v *City of Wyoming*, 10 MTT 664 (1999), MTT Docket No. 195925. "The capitalization-of-income method has been described as the most appropriate method for evaluating the TCV of income-producing property."' *First City Corp* v *Lansing*, 153 Mich App 106, 116 (1986). The Tribunal concurs with Petitioner's contention that in this case the sales comparison method should be given little or no weight because there is "an absence of reliable and complete information to disclose the factors which influence a buyer's decision." Petitioner's Post Hearing Brief, page 4. In the absence of very similar properties in terms of size, quality and location, no knowledgeable investor would place reliance on the sales comparison method.

Petitioner correctly notes that the parties agree that the property is well maintained, the rents are consistent with the market, and the property is expected to generate approximately $600,000 in potential gross income. Both appraisers used the income approach and the sales comparison approach, although Respondent's expert relied more heavily upon the sales approach due to his belief that there was a lack of credible and complete information regarding the income and expenses. The Tribunal gives little weight to the sales comparison method, due to the inherent difficulties in adjusting for differences between the comps, which varied significantly in size, quality, and location. Although Petitioner attempted to select comps from similar small town markets, the comps in Dewitt, Eaton Rapids, and East Lansing are distant from Durand and are more significantly influenced by the Lansing market, making accurate adjustments for location difficult. Overall, the sales comparison method is found be have limited reliability as applied in this case.

Based on the foregoing findings of fact and conclusions of law, the Tribunal relies most heavily upon the direct capitalization of income method, utilizing the income, expenses, and OAR set forth in the Findings of Fact section of the this opinion, which results in a conclusion of TCV for the first tax year at issue, summarized as follows:

Net Operating Income	/	Cap Rate	=	TCV
$364,214	/	13.0325%	=	$2,796,269

The resulting estimate of TCV is reconciled with all competent evidence and rounded to $2,800,000 for the 2003 tax year; increased for market conditions to $2,864,400 for the 2004 tax year; and held to be $2,864,400 for the 2005 tax year. There is no increase for 2005 based on Respondent's final contention that no increase for market conditions is warranted for that year.

JUDGMENT

IT IS ORDERED that the true cash values, assessments and taxable values for the subject property for the tax years at issue shall be those specified in the "Tribunal's Conclusions of Assessment and True Cash Value" portion of this Opinion and Judgment.

IT IS FURTHER ORDERED that the persons having responsibility for the assessment roll for the tax years at issue shall correct or cause the assessment rolls to be corrected to reflect the assessment (and taxable value) in the amounts as finally shown in the "Conclusions of Law" section of this opinion (also see, the "Tribunal's Conclusions of Assessed and True Cash Values," section of this Proposed Opinion), subject to the processes of equalization, within 20 days of the date of entry of this order.

IT IS FURTHER ORDERED that the officer charged with collecting or refunding the affected taxes shall collect taxes, any applicable interest, or issue a refund within 20 days after the entry of this order. If a refund is warranted, it shall include a proportionate share of any property tax administration fees paid and of penalty and interest paid on delinquent taxes. The refund shall also separately indicate the amount of taxes, fees, penalties, and interest being refunded. A sum determined, by the Tribunal, to have been unlawfully paid shall bear interest from the date of payment to the date judgment and the judgment shall bear interest to the date of its payment. A sum determined by the Tribunal to have been underpaid shall not bear interest for anytime period prior to 28 days after the issuance of the Tribunal's decision. As provided by 1994 PA 254 and 1995 PA 232, being MCL 205.737, as amended, interest shall accrue for periods after March 31, 1985, but before April, 1994, at a rate of 9% per year. After March 31, 1004, but before January, 1996, interest shall accrue at an interest rate set monthly at a per annum rate based at the auction rate of 91-day discount treasury bill rate for the first Monday in cash month, plus 1 %. Pursuant to 1995 PA 232, interest shall accrue (i) after December 31, 1995, at a rate of 6.55 % for calendar year 1996, (ii) after December 31,1996 at a rate of 6.11% for calendar year 1997, (iii) after December 31, 1997, at a rate of 6.03% for calendar year 1998, (iv) after December 31, 1998, at a rate of 6.01% for the calendar 1999, (v) after December 31, 1999, at a rate of 5.49% for calendar year 2000, and (vi) after December 31, 2000, at a rate of 6.56% for calendar year 2001, (vii) after December 31, 2001, at a rate of 5.56%for calendar year 2002, and (viii) after December 31, 2002, at a rate of 2.78% for calendar year 2003, (ix) after December 31, 2003 at a rate of 2.16% for calendar year 2004, (x) after December 31, 2004, at the rate of 2.07% for calendar year 2005, (xi) and after December 31, 2005, at the rate of 3.66% for calendar year 2006.

MICHIGAN TAX TRIBUNAL

Entered: February 27, 2006 By: Thomas A. Halick

This Proposed Opinion and Judgment ("Proposed Opinion") was prepared by the State Office of Administrative Hearings and Rules. The parties have 20 days from date of entry of this Proposed Opinion to notify the Tribunal in writing if they do not agree with the Proposed Opinion and why they do not agree (i.e., exceptions). After the expiration of the 20-day time period, the Tribunal will review the Proposed Opinion and consider the exceptions, if any, and:

a. Adopt the Proposed Opinion as a Final Decision.
b. Modify the Proposed Opinion and adopt it as a Final Decision.
c. Order a rehearing or take such other action as is necessary and appropriate.

The exceptions are limited to the evidence submitted prior to or at the hearing and any matter addressed in the Proposed Opinion. There is no fee for the filing of exceptions. A copy of a party's written exceptions must be sent to the opposing party.